COMMONWEALTH OF MASSACHUSETTS
DEPARTMENT OF TELECOMMUNICATIONS AND ENERGY

D.T.E. 05-___

PREFILED TESTIMONY OF RICHARD N. MARSHALL

I. INTRODUCTION

Q. Please state your name and business address.

A. My name is Richard N. Marshall. My business address is One PEI Center, Wilkes-Barre, Pennsylvania 18711.

Q. By whom are you employed and in what capacity?

A. I am the Vice President and Treasurer of Southern Union Company ("Southern Union" or the "Company") and am responsible for capital-market financing, debt management, cash management and investor relations activities of the Company.

Q. Have you previously testified before this or any other Commission?

A. Yes. Most recently, I submitted pre-filed testimony on behalf of the Company for approval and authorization from the Department of Telecommunications and Energy (the "Department") pursuant to G.L. c. 164, § 14 and 16 for approval to issue up to $590.5 million in common stock and equity units for the purpose of funding an investment in CCE Holdings, LLC (D.T.E. 04-83). I have testified in a number of other cases before the Department, including the Company's request to issue approximately 4.25 million shares of common stock to stockholders of record in 2004. Southern Union Company, D.T.E. 04-41 (2004). In addition to cases before the Department, I have testified before the Pennsylvania Public

Utility Commission on behalf of PG Energy in connection with several base-rate increase filings, including Docket Nos. R-00005119, R-00984280 and R-00963612.

Q. Would you please provide a brief description of the Company?

A. Southern Union Company is a Delaware corporation that is primarily involved in the distribution, transportation and storage of natural gas throughout the United States. As a natural gas local distribution company, Southern Union serves approximately 1.0 million customers through operating divisions in Missouri, Pennsylvania, Rhode Island, and Massachusetts. In Rhode Island and Massachusetts, Southern Union serves approximately 300,000 customers through the New England Gas Company, which is an operating division of the Company. The Company also serves approximately 500,000 customers through its operations in Missouri (Missouri Gas Energy) and 160,000 customers through its operations in Pennsylvania (PG Energy). Through Panhandle Energy, the Company owns and operates 100% of Panhandle Eastern Pipe Line Company, Trunkline Gas Company, Sea Robin Pipeline Company, Southwest Gas Storage Company and Trunkline LNG Company – one of North America's largest liquefied natural gas import terminals. Through CCE Holdings, LLC, Southern Union also owns a 50% interest in and operates the CrossCountry Energy pipelines, which include 100% of Transwestern Pipeline Company and 50% of Citrus Corp. Citrus Corp. owns 100% of the Florida Gas Transmission pipeline system. Southern Union's pipeline interests operate more than 18,000 miles of interstate pipelines that transport natural gas from the San Juan, Anadarko and Permian Basins, the Rockies, the Gulf of Mexico, Mobile Bay, South Texas and the Panhandle regions of Texas and Oklahoma to major markets in the Southeast, West, Midwest and Great Lakes region.

Q. What is the purpose of your testimony?

A. My testimony describes and supports the Company's request for authorization to issue and distribute up to 5,500,000 shares of common stock for the purpose of effecting a stock dividend in 2005. The issuance of the stock dividend serves a legitimate utility purpose because it enables the Company to use retained earnings to finance ongoing operations in a cost-effective manner. My testimony also demonstrates that the issuance meets the "net-plant test" as has been established by the Department pursuant to G.L. c. 164, § 16.

II. DESCRIPTION OF THE PROPOSED ISSUANCE

Q. For how many shares is the Company seeking the Department's authorization?

A. The Company is seeking authorization to issue up to 5,500,000 shares of common stock for the purpose of completing the stock dividend. It is anticipated that the Company would declare the stock dividend authorized in this proceeding on or about July 15, 2005, so that distribution of the shares can take place by August 15, 2005. The Company's Board of Directors voted on May 9, 2005 to authorize the dividend. The actual number of shares to be issued in order to accomplish the dividend will be determined on the issue date and will be reported to the Department in a compliance filing.

Q. How did the Company determine the number of shares to be issued?

A. As of April 29, 2005, the Company had approximately 105.6 million shares of common stock outstanding to which the five percent stock dividend would apply. A five percent dividend would entail approximately 5.3 million shares based on shares outstanding as of April 29, 2005. Accordingly, the Company is requesting authorization to issue up to 5,500,000 shares to ensure that the stock dividend can be completed without further review and authorization by the Department.

Q. Has the Company's Board of Directors voted to authorize the issuance of common stock?

A. On May 9, 2005, the Company's Board of Directors authorized the issuance of common stock in furtherance of the distribution of a stock dividend as required by G.L. c. 164, § 14. A copy of the vote of the Board of Directors is provided herewith as Exhibit SU-2.

Q. Please describe the process to issue the stock dividend.

A. Southern Union has issued an annual five percent stock dividend since 1994. Typically, the Board of Directors meets in the month of June to declare the dividend as a percentage of outstanding shares of stock, to set the record and distribution dates, and to authorize the issuance of shares to accomplish the stock dividend. The stock dividend is announced to shareholders on the declaration date and is issued to all holders of Southern Union stock as of the record date, which is usually set around 10 days following the declaration date. The issuance date is set for approximately 10 days to two weeks following the record date. For example, last year, the stock dividend was declared on August 10, 2004, and all holders of record as of August 20, 2004, received the dividend. The Company distributed shares in connection with the stock dividend on August 31, 2004. To provide for a five percent dividend in 2004, the Company issued approximately 3.7 million shares.

Q. Will the Company adhere to the same process this year in issuing the stock dividend?

A. Yes. From a market perspective, it is important for the Company to declare and issue the annual dividend in the same time frame as it has in the past because the market may react negatively to variation from past practices. As it has in the past, the stock dividend will be declared immediately following the issuance of the Department's decision in this proceeding.

Q. Why is the distribution of a stock dividend an important corporate policy for the Company?

A. The issuance of a stock dividend is an important corporate policy for the Company for a number of reasons. First, the distribution of a stock dividend rather than the payment of a cash dividend allows the Company to use its retained earnings to fund utility operations without having to raise additional debt or equity in the capital markets. Second, the distribution of a dividend enables the Company to use retained earnings to repay debt and improve its capitalization ratios. Third, the distribution of a stock dividend increases the number of shares that are available to be traded in the marketplace, which increases the liquidity of the Company's stock.

Q. How does the distribution of a stock dividend increase the Company's equity capitalization?

A. The issuance of a stock dividend enables the Company to retain and use earnings for the purpose of financing utility operations and repaying long-term debt. By using earnings to finance a portion of its capital additions, the Company is able to avoid turning to the capital markets to raise the levels of debt and equity capital that would be needed if earnings were paid out in cash to shareholders each year. In addition, the Company uses earnings and cash generated by its distribution operations to repay long-term debt. When the need for new long-term debt is avoided and existing debt is repaid, the Company's equity ratios improve. Thus, the issuance of a stock dividend is an important tool for the Company in maintaining and improving cash flow and achieving appropriate balance sheet capitalization ratios.

Q. How is the stock dividend and use of retained earnings to fund utility operations a cost-effective way of securing and maintaining adequate equity capitalization?

A. Although equity is generally a more expensive source of capital than debt, the Department has long recognized that a balanced capital structure is preferable in terms of ensuring the overall financial health of a utility. Balanced capital structures are needed in order for utilities to maintain investment-grade ratings and to ensure cost-effective access to the capital markets. Consistent with industry practice, the Company funds its utility operations through a combination of debt and equity, with the majority of the Company's equity financing since 1994 resulting from the contribution of retained earnings to the funding resources used by the Company. Thus, the stock-dividend policy has allowed the Company to fund a modest and appropriate amount of capital additions with equity, which is consistent with general utility ratemaking principles.

The stock-dividend policy is a cost-effective way of maintaining appropriate equity ratios because it allows the Company to grow equity through earnings and limits the need for, and size of, common stock issuances in the public markets. Common equity offerings involve transaction expenses, including underwriter fees, brokerage commissions, fees paid to the Securities Exchange Commission, legal expenses and documentation expenses. Since the implementation of the stock-dividend policy, the Company has limited its need for public offering, and therefore, has avoided these types of costs.

Q. How is the Company's stock dividend policy viewed by lenders and debt rating agencies?

A. Financial analysts evaluating the Company's financial operations have recognized that the stock-dividend policy allows the Company to: (1) maximize cash flows available for capital expenditures and debt reduction; (2) reduce the need for external financing; and (3) increase equity ratios. Financial analysts have specifically recognized that the stock-dividend policy has enabled the Company to deleverage quickly without the need to raise common equity through public market issuances. Therefore, the Company's stock-dividend policy, and its favorable impact on cash flow, has been positively received by the Company's financial institutional lenders. Moreover, from an investment rating perspective, the Company is considered to be a "low business risk" natural gas distribution company with investment-grade ratings from Moody's (Baa3), Standard & Poor's (BBB) and Fitch Ratings (BBB). Specifically, Moody's has stated that it views the Company's stock dividend policy favorably "since it maximizes the cash flows available for capital expenditures and debt reduction, reduces the need for external financing, and helps increase its equity." Fitch Ratings also lists the Company's dividend policy as one of its "Key Credit Strengths" stating the "no-cash dividend policy maximizes free cash flow."

Q. What is the value of the Company's stock-dividend policy for shareholders?

A. The Company's policy of distributing a stock dividend is of significant value to the Company's shareholders. The Company's shareholders expect and desire the stock dividend because it places the timing of any taxable event in the hands of the individual shareholder. Cash dividends received by investors must be treated as ordinary income for tax purposes. Conversely, the receipt of a stock dividend is not a taxable event for the shareholder. If a shareholder chooses to sell his or her shares and receive cash, the shareholder will be taxed only on the gain. This creates two benefits for shareholders: (1) the shareholder is allowed to deduct his or her "basis" in the stock, which reduces the amount that is subject to taxation; and (2) the shareholder pays tax at the generally more beneficial capital-gains rate. Accordingly, the Company's corporate policy of issuing stock dividends is disclosed in all major financial reports of the Company and an elimination of the stock dividend could have the effect of diminishing the value of the Company's equity in the eyes of its shareholders.

Q. Is it possible for shareholders to receive a cash payment in lieu of a stock dividend payment?

A. The Company has in place a Stock Dividend Sale Plan (the "Sale Plan"), which provides eligible owners of the common stock of the Company the opportunity to sell shares received as stock dividends. The Company pays all costs under the Sale Plan. Under this plan, shareholders may elect, at a point prior to the record date, to sell their dividend shares through the Sale Plan. Shareholders making such an election are issued the shares and then the shares are sold through the Plan Broker. The Plan Broker aggregates the shares offered for sale and shareholders receive payment for their shares based on the average price obtained for the aggregated shares. The vast majority of the Company's shareholders do not participate in this plan. For example, in 2004, approximately 200,472 shares were sold through the Sale Plan in comparison to an issuance of 3.7 million shares.

Q. How will the issuance of additional shares of common stock for distribution of a stock dividend affect the value of the shares held by the Company's existing shareholders?

A. As noted above, the dividend shares are issued only to existing shareholders (as of the record date) on a pro rata basis so that the shareholders' percentage ownership of the Company is unchanged by the issuance. In addition, the issuance of the additional shares does not change the total of the common stockholders' equity section of the balance sheet. This ensures that the total value of the ownership shares held by existing shareholders is not affected by the stock dividend, which for the Department's purposes is similar to the effect of a stock split. Moreover, as described below, the Company's net-utility plant exceeds its total capitalization, and therefore, no impairment of the Company's capital stock will occur as a result of the stock issuance.

Q. Will the issuance of additional shares of common stock for distribution of a stock dividend affect customers?

A. The issuance of additional shares of common stock for distribution of a stock dividend will not affect customers and will, over the long term, assist the Company in maintaining adequate equity ratios and ensuring that the Company's cost of debt is consistent with its investment grade rating.

Q. In your opinion, is the stock issuance in the public interest?

A. Yes. The proposed issuance of up to 5,500,000 shares of common stock is reasonably necessary to fund expenditures for the extension and improvement of utility plant, to repay long-term debt, and to maintain the Company's access to cost-effective capital. As a result, the issuance serves a legitimate purpose in meeting the Company's service obligations. As discussed below, the issuance also meets the Department's "net-plant test," established pursuant to G.L. c. 164, § 16. Therefore, consistent with Department precedent, the issuance is in the public interest.

III. NET-PLANT TEST

Q. Please describe Exhibit SU-3.

A. Exhibit SU-3 presents the pre-issuance comparison of net utility plant to total capitalization after certain adjustments are made to the most recent consolidated balance sheet consistent with Department precedent. Exhibit SU-3 also presents the post-issuance comparison of net utility plant to total capitalization following the issuance of up to 5,500,000 shares for the stock dividend.

To calculate the pre-issuance net plant test, Column A of Exhibit SU-3 duplicates information provided in the Company's Form 10-Q for the quarterly period ending March 31, 2005, which was filed with the Securities and Exchange Commission on May 9, 2005. This Form 10-Q is provided in Exhibit SU-4.

Column B of Exhibit SU-3 sets forth five adjustments required under Department precedent, which are designed to: (1) remove the property, plant and equipment and associated capitalization for unregulated operations; (2) remove the net goodwill reflected on the Company's books and the associated capitalization; (3) remove accumulated other comprehensive income; (4) remove retained earnings; and (5) remove Construction Work in Progress and non-regulated inventories from the net-plant calculation. As discussed below, Column B also contains adjustments to account for the issuance of 5.5 million shares to accomplish the stock dividend.

Column C of Exhibit SU-3 sets forth the adjusted, pre-issuance comparison of net utility plant to total capitalization. As shown therein, the Company's net utility plant as of March 31, 2005 exceeds total capitalization by $136,760,000.

Q. Please describe the present capitalization of the Company and indicate the ownership of its outstanding securities.

A. As shown in Column A of Exhibit SU-3, there were approximately 105.9 million shares of common stock outstanding at a par value of $1.00 per share, or approximately $105,913,000 as of March 31, 2005. Premium on capital stock totaled $1,520,615,000. Also as of March 31, 2005, treasury stock was valued at $12,870,000. Treasury stock represents shares that are issued and have been repurchased by the Company, and therefore represent a deduction from common stockholders' equity. Common stock held in trust and deferred compensation totaled $3,239,000 and reflects shares held in various grantor trusts or "rabbi trusts," which are established to fund deferred compensation for key employees and directors of the Company. The Company also had an accumulated other comprehensive loss of $57,946,000 and retained earnings of $135,899,000. Therefore, Common Stockholders' Equity totaled $1,688,372,000.

The Company's long-term debt and capital lease obligations as of March 31, 2005 totaled approximately $2,604,404,000 (including $230 million in preferred securities issued in October 2003 and the outstanding balance of the Company's revolving credit agreement listed in the 10-Q as "Notes Payable"), resulting in a total capitalization of $4,292,776,000.

Q. Would you please review the adjustments to the consolidated balance sheet as of March 31, 2005 set forth in Exhibit SU-3?

A. Yes. The Company has made a number of pro forma adjustments to its consolidated balance sheet for the purpose of comparing the post-issuance net-utility plant to total capitalization. These adjustments are set forth in Column B of Exhibit SU-3. As discussed below, these adjustments are consistent with Department precedent.

First, the Company removed from Property, Plant and Equipment, the net property, plant and equipment relating to unregulated business operations. Specifically, as shown in Exhibit SU-3, the Company reduced its net plant-in-service by $14,358,000 (plant-in-service of approximately $17,460,000, less accumulated depreciation of approximately $3,102,000), to account for unregulated operations that are shown on a consolidated basis on the Company's balance sheet.

The unregulated property, plant and equipment removed from the net-utility plant-in-service is supported by a combination of debt and equity, but having been incorporated over time into the Company's overall operations, cannot be directly attributed to a particular source of capital. Accordingly, the Company has reduced its total capitalization in the amount of $14,358,000 by reducing outstanding debt and equity in the same ratio that those categories of capital have to the Company's total capitalization. This adjustment is consistent with the Department's treatment in previous cases presented by Southern Union and with the Department's precedent, which requires a utility to demonstrate that its net-utility plant-in-service will be equal to or exceed its total capitalization following the issuance of the security for which it is seeking authorization by the Department. This adjustment (to both net utility plant and total capitalization) is denoted on Exhibit SU-3 as adjustment (A).

Second, the Company adjusted the net-plant-test calculation to exclude the net goodwill totaling $640,547,000 from the Company's overall capitalization. Over the past several years, the Company completed a number of acquisitions of regulated natural gas companies. The net goodwill of $640,547,000 reflects the excess of the purchase prices of the acquired companies over the book value of the assets acquired. Thus, the Company reduced its total capitalization by $640,547,000 to reflect the removal of the net goodwill from the net-plant-test calculation. This is consistent with the Department's treatment of additional purchase costs in previous cases presented by Southern Union and with prior Department precedent.

The net goodwill is supported by a combination of debt and equity, but having been incorporated over time into the Company's overall operations, cannot be directly attributed to a particular source of capital. Accordingly, the Company has reduced its total capitalization in the amount of $640,547,000 by reducing outstanding debt and equity in the same ratio that those categories of capital have to the Company's total capitalization. This adjustment (to both net-utility plant and total capitalization) is denoted on Exhibit SU-3 as adjustment (B).

Third, the Company excluded the Accumulated Other Comprehensive Loss of approximately $57,946,000 from its total capitalization. The exclusion of Accumulated Other Comprehensive Loss is denoted on Exhibit SU-3 as adjustment (C).

Fourth, the Company excluded Retained Earnings of approximately $3,899,000 from its total capitalization. The exclusion of Retained Earnings for net-plant purposes is denoted as adjustment (D) on Exhibit SU-3. As discussed in relation to adjustment (G) below, the balance of Retained Earnings ($132,000,000) is excluded from the net-plant test as part of the entry to account for the stock dividend in accordance with the Department's ruling in Southern Union Company, D.T.E. 04-41 (2004).

Fifth, the Company has made pro-forma adjustments to its consolidated balance sheet to remove Construction Work In Progress of $275,837,000 (denoted as adjustment (E)), and to reduce net plant by $6,310,000 for unregulated inventories that are shown on a consolidated basis on the Company's balance sheet (denoted as adjustment (F)), as calculated on Exhibit SU-3.

As noted above, adjustment (G) on Exhibit SU-3 adjusts the Company's capitalization to record the issuance of the stock dividend. In D.T.E. 04-41 at pages 15-16, the Department directed the Company to include the reduction to retained earnings that results from the accounting entries for the stock dividend in the net-plant test computations. Therefore, consistent with the Department's instructions, the Company has reduced Retained Earnings by $132,000,000 to account for the issuance of 5.5 million shares at $24 per share (the per share market value of the Company's stock). Adjustment (G) also shows that Common Stock, $1 Par Value is increased by $5,500,000 and Premium on Capital Stock is increased by $126,500,000 (increasing Common Stockholders' Equity in total by $132,000,000) to account for the issuance of 5.5 million shares of common stock for distribution to shareholders.

Although the Department has not yet ruled on the Company's Motion for Reconsideration (the "Motion") filed in relation to the Department's final order in D.T.E. 04-41, the Company's net-plant test calculation is consistent with the Department's directives in that case. In the Motion, the Company acknowledged that the increase to Common Stockholders' Equity that occurs as a result of the GAAP accounting entries to record the stock dividend (which transfer Retained Earnings to Common Stock, $1 Par Value and Premium on Capital Stock), should be reflected in the net-plant test calculation. The Company sought reconsideration only of the Department's decision to increase capitalization for net plant purposes by the "market value" of the stock dividend, *when the market value exceeded Retained Earnings*. In this case, multiplying the number of shares to be issued for the stock dividend (5.5 million) by the current market price ($24) results in an amount ($132,000,000) that is less than the total amount of Retained

Earnings recorded on the Company's books as of March 31, 2005 ($135,899,000) and is consistent with the GAAP accounting entries that will be undertaken to account for the stock dividend. Therefore, the concern raised by the Company in the Motion is not an issue in calculating the net-plant test in this case. However, because the circumstances may be different in the future, the Company appreciates the Department's ongoing review of the Motion for Reconsideration.

As shown by the calculations set forth in Exhibit SU-3, the Company's net-plant in service exceeds capitalization by approximately $136,760,000 following the issuance of the stock dividend.

Q. Does this complete your testimony?

A. Yes, it does.